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In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 73-1652

YOUR HOST, INC., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. A 16-51) are reported at 58 T.C. 10. The opinion of the court of appeals (Pet. App. B 52-67) is reported at 489 F. 2d 957.

JURISDICTION

The judgment of the court of appeals was entered on December 11, 1973 (Pet. App. C 68-69). A petition for rehearing was denied on February 6, 1974 (Pet. App. C 69). The petition for a writ of certiorari was filed on May 7, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether Section 482 of the Internal Revenue Code of 1954 empowers the Commissioner to reallocate all of

the income reported by one commonly controlled corporation to another such corporation.

2. Whether Section 482 empowers the Commissioner to reallocate income from one commonly controlled corporation to another, even though the tax result achieved is the same as a disallowance of the Section 11(d) $25,000 corporate surtax exemption of the corporation from which the income is reallocated.

3. Whether the Commissioner's determination, that the acquisition of a corporation was for the principal purpose of tax evasion or avoidance within the meaning of Section 269 of the Code and that the acquired corporation therefore was not entitled to the corporate surtax exemption, constitutes a denial of due process because previous audits had not resulted in such a determination.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 269. ACQUISITIONS MADE TO EVADE OR AVOID INDOME TAX.

(a) *In General.* If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between, or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

STATEMENT

Petitioner and its affiliates operate a restaurant chain and food business in the Buffalo, New York, area. The business began in 1944 as a single-restaurant partnership between A. J. Durrenberger and R. T. Wesson. During the

period 1947 through 1958, the business expanded and a group of corporations under common control was organized to engage in the operation of restaurants, a food supply commissary (Sher-Del-Foods, Inc.), a bakery (Your Host Bakery, Inc.), a real estate holding company (Alro, Inc.), and vending machine and leasehold operations. Petitioner Your Host, Inc., the first and principal corporation of the group, owns and operates fifteen "Your Host" restaurants. The other restaurants are owned by ten different corporations, none of which have more than four restaurants. All of these enterprises remained under the control of the two original partners and later, after Wesson's death in 1956, under the control of Durrenberger alone (Pet. App. B 54-55 and n. 3).

Pursuant to the Commissioner's authority under Section 482 of the Code to allocate income between commonly controlled corporations, if he determines that such allocation is necessary in order to prevent evasion of taxes or clearly to reflect their income, all of the income reported by the ten restaurant corporations and by Chef Foods, Inc., for their taxable years ending in 1965 through 1968, was allocated to petitioner Your Host, Inc. The Commissioner further allocated for these years all of the income reported by Your Host Bakery, Inc., to Sher-Del-Foods, Inc. The Tax Court sustained the allocations of the income of Chef Foods and Your Host Bakery but not of the ten restaurant corporations (Pet. App. A 45-46). However, the Tax Court sustained the Commissioner's alternative position under Section 269 of the Code disallowing the $25,000 corporate surtax exemptions of four of the restaurant corporations and of Alro, the real estate corporation, on the ground that the principal purpose for the formation of these corporations was the

avoidance of taxes (Pet. App. A 46).[1] The court of appeals affirmed, with one judge dissenting in part.

ARGUMENT

1. Section 482 of the Internal Revenue Code of 1954 empowers the Commissioner to "allocate gross income" among commonly controlled business entities, if he determines that such allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of such business entities. The statute is based upon the "well-settled policy that income is taxable under Section 61 of the 1954 Code to the party who earns it and that it is economic reality rather than legal formality which determines who earns income." *Philipp Brothers Chenicals, Inc. (N.Y.)* v. *Commissioner*, 435 F. 2d 53, 57 (C.A. 2). At the time of its original enactment as Section 45 of the Revenue Act of 1928 the scope of the provision was explained in H. Rep. No. 2, 70th Cong., 1st Sess., pp. 16-17, as follows:

> The section of the new bill provides that the Commissioner may, in the case of two or more trades or businesses owned or controlled by the same interests, apportion, allocate, or distribute the income or deductions between or among them, as may be necessary in order to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods

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[1] Because the Tax Court sustained the Commissioner's primary Section 482 allocation of the income of Chef Foods and Your Host Bakery to Your Host and Sher-Del-Foods, it did not have to reach the alternative Section 269 issue concerning disallowance of the corporate surtax exemptions of Chef Foods and Your Host Bakery. We have accordingly filed a petition for a writ of certiorari (No. 73-1687) in order to protect the revenue by preserving this alternative position. The petition in No. 73-1687 should be granted only if the Court grants this petition.

frequently adopted for the purpose of "milking"), and in order clearly to reflect their true tax liability.

As this Court recognized in *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394, 400, the relevant Treasury Regulation (Section 1.482-1(b)(1)), provides that the standard to be applied under Section 482 is "'that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.'" Thus, Section 482 empowers the Commissioner to examine transactions between controlled taxable entities in order to determine whether they would have been concluded in an arm's-lenth negotiation between strangers, and to make a reallocation when they fail to meet that standard. It is firmly established that such determinations can be set aside only if unreasonable, arbitrary, or capricious. See, *e.g.*, *Wisconsin Big Boy Corp.* v. *Commissioner*, 452 F. 2d 137, 140 (C.A. 7), and cases cited therein.

Petitioners principally argue (Pet. 10-12) that there is a fundamental conflict among the circuits as to the scope of the Commissioner's authority under Section 482. They urge that the Commissioner is never authorized to allocate all of the income of one corporation to another because the result would be equivalent to the result achieved by the filing of a consolidated return. In support of their position, petitioners cite *Commissioner* v. *Chelsea Products, Inc.*, 197 F. 2d 620 (C.A. 3), and assert a conflict between that case and the decision below and *Wisconsin Big Boy Corp.* v. *Commissioner, supra.*

This position, however, was rejected long ago by the Second Circuit in *Advance Machinery Exch.* v. *Commissioner*, 196 F. 2d 1006, certiorari denied, 344 U.S. 835, which upheld an allocation of all of the income of several

controlled entities to another.[2] In rejecting the contention that the statute did not authorize a total allocation, the court noted that such a rule "would exclude from the 'policing' provisions of § [482] the most flagrant evasion by arbitrary shifting of income." The court further observed that if such a limitation were imposed upon the Commissioner's authority, "tax evasion could be so complete as to make itself invulnerable, a proposition whose statement discloses its fallacy" (196 F. 2d at 1009). And, contrary to petitioner's argument, *Chelsea Products* did not hold that the Commissioner cannot as a matter of law allocate all of a corporation's income under Section 482. While there is dictum in *Chelsea Products* suggesting that the Commissioner's allocation "proceeded beyond his statutory bounds" (197 F. 2d at 623), the Third Circuit emphasized that the basis of its decision was the Tax Court's finding that the corporations involved each conducted a business enterprise separate from the taxpayer and that their income was not earned by the taxpayer. The court distinguished the Second Circuit's *Advance Machinery* decision (rendered one month before) on this ground (197 F. 2d at 623-624, n. 6), and this Court denied a petition for a writ of certiorari in *Advance Machinery* which had urged the same alleged conflict with *Chelsea Products* urged by petitioners here. Significantly, no case since *Chelsea Products* has even suggested that the Commissioner cannot allocate all of a corporation's income merely because

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[2]Thus, petitioners' contention (Pet. 10-11) that the courts did not permit total allocations until the 1964 decision of the Tax Court in *Hamburger's York Road, Inc.* v. *Commissioner*, 41 T.C. 821, is refuted by the *Advance Machinery Exchange* decision which was rendered in 1952.

the result achieved is similar to that under a consolidated return.[3]

3. Petitioners further contend (Pet. 9) that the total allocation of the income of Chef Foods and Your Host Bakery cannot stand because a lesser allocation was more appropriate. But as the court of appeals observed with respect to Chef Foods, "the actual scope of its operations, in terms of its labor force, capitalization, work site, and so forth, suggests that the firm was kindred in nature to the kind of sham enterprise which [that] court held properly subject to income allocation in *Philipp Bros. Chemicals, Inc.* v. *C.I.R.* [435 F. 2d 53]" (Pet. App. B 58). Indeed, petitioners have pointed to nothing in the record which suggests that Chef Foods earned any of the income it reported. Thus, while purchases and sales of cigarettes in vending machines located in "Your Host" restaurants and rental of refrigeration and storage facilities were conducted in the name of Chef Foods, the record indicates that it incurred no office, telephone, or automobile expenses, sustained $179 of repair expenses, and purchased $160 of operating supplies during the four years at issue (Pet. App. B 57; R. 277-282, Exs. 79-CA through 82-CD).[4] In light

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[3] *W. Braun Co., Inc.* v. *Commissioner*, 396 F. 2d 264 (C.A. 2), cited by petitioners (Pet. 7-10), is not to the contrary. Apart from the fact that it does not establish an inter-circuit conflict, the court there rejected a Section 482 allocation of all of a corporation's income because it conducted substantial business activities and earned its own income.

Nor does Section 1.482-1(b)(3) of the Treasury Regulations (Pet. 7) prevent the Commissioner from making a total allocation under Section 482. As the Second Circuit explained in *Advance Machinery*, that provision simpy means that the Commissioner is not free to compel affiliated corporations to file a consolidated return (196 F. 2d at 1009).

[4] "R." and "Ex." references are respectively to the joint appendix filed in the court of appeals and the trial exhibits.

of this gross imbalance between Chef Foods' annual receipts ($160,000) and its virtually non-existent expenses, both courts below were amply justified in concluding that the Commissioner's allocation of all of its income was neither arbitrary nor unreasonable.

Petitioners have likewise failed to show that the Commissioner's allocation of all of Your Host Bakery's income to Sher-Del-Foods was arbitrary or unreasonable. It is undisputed that the bakery sold virtually all of its products to Sher-Del-Foods, which in turn sold them at its cost to the various "Your Host" restaurants. Thus, the entire profit of the baking part of the enterprise was shifted to Your Host Bakery despite the fact that Sher-Del-Foods would have received part of the profit if sales of the baked goods had been made to an unrelated third party. It is therefore beyond doubt that these sales did not meet the standard prescribed by Treasury Regulations, Section 1.482-1(b) (1) of "an uncontrolled taxpayer dealing at arms's length with another uncontrolled taxpayer."

Although petitioners appear to acknowledge (Pet. 9) that some allocation of income from Your Host Bakery to Sher-Del-Foods would be proper, they claim to have proved that an allocation of less than 100 percent is required. They urge that they are entitled to a remand to the Tax Court in order to prove the exact amount of the correct allocation. But it is well settled that a taxpayer seeking to overcome a Section 482 allocation has the burden of proving more than simply that the allocation may be erroneous. The burden of proving that a Section 482 determination by the Commissioner is arbitrary requires a showing as to what other allocation would have been more appropriate under the "arm's length" standard of the statute. See *Grenada Industries, Inc.* v. *Commissioner*, 17 T.C. 231, 258-259, affirmed, 202 F. 2d 873 (C.A. 5); *Wisconsin Big Boy Corp.* v. *Commissioner, supra*, 452 F. 2d at 140.

Thus, a generalized claim that a total allocation is inappropriate, without more, is insufficient to overturn a Section 482 allocation. In order to demonstrate that such an allocation is arbitrary or unreasonable, the taxpayer must come forward with proof of what allocation, if any, would be proper. Here, the only evidence petitioners submitted was the gross income and expenses as reported by Your Host Bakery and the number of its employees. Petitioners claim that a total allocation cannot be sustained in light of those facts. But petitioners introduced no evidence to show what profits a bakery enterprise comparable to Your Host Bakery should have earned or what profits Sher-Del-Foods earned prior to the formation of Your Host Bakery when it dealt with an uncontrolled bakery. Thus, on this record, the Tax Court had no basis upon which to approve a lesser allocation of income from Your Host Bakery to Sher-Del-Foods. In these circumstances, the courts below had little alternative other than to sustain the Commissioner's allocation as neither arbitrary nor unreasonable. As the Second Circuit stated in *Philipp Brothers Chemicals, Inc. (N.Y.)* v. *Commissioner, supra,* 435 F. 2d at 59, in a passage the court of appeals found equally appropriate here (Pet. App. B 59):

> [T]he taxpayer had the burden of showing that the 100% allocation of income to the [parent] corporation was unjustified. Taxpayers ask us to remand the case in order to allow them an opportunity to establish that the 100 percent allocation was unreasonable and to show what a reasonable allocation would be. We see no reason for according them another chance. * * *

Contrary to petitioner's assertion (Pet. 9), the decision below does not conflict with *Helvering* v. *Taylor*, 293 U.S. 507. In that case, which did not involve Section 482, this Court held that where specific valuation evidence sub-

mitted by the taxpayer to the Board of Tax Appeals demonstrated that the Commissioner's apportionment of cost between two kinds of stock was arbitrary and excessive, it could not sustain the Commissioner's determination on the ground that the taxpayer did not introduce any evidence showing the correct amount of the tax. Under those circumstances, the Court declared that the Board should have held a further hearing to receive additional evidence in accordance with its statutory obligation under the predecessor of Section 6213(a) to conduct "a redetermination of the deficiency." See also Section 7459. Here, however, the Tax Court did not sustain the Commissioner's Section 482 determination in the face of any cogent evidence that it was either arbitary or unreasonable. Indeed, no such finding could have been made in light of petitioner's utter failure to meet its special burden of proving the allocation arbitrary or unreasonable by showing what the correct allocation would be under the "arm's length" standard of Section 482.[5]

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[5]Nor do *Baldwin-Lima-Hamilton Corp.* v. *United States*, 435 F. 2d 182 (C.A. 7) or *Lufkin Foundry & Machine Co.* v. *Commissioner*, 468 F. 2d 805 (C.A. 5)(Pet. 9), conflict with the decision below. In the former case, the district court concluded that the Commissioner's allocation of total income was arbitrary and unreasonable. The court of appeals found that certain evidence submitted by the taxpayer contained erroneous assumptions which would unquestionably require a modification of the district court's decision. Accordingly, it remanded the case for recomputation of the allocation in light of its opinion.

Lufkin does not involve a total allocation. There the Tax Court held that the evidence submitted by the taxpayer was sufficient to set aside the Commissioner's Section 482 allocation of 50 percent of two corporations' income. The court of appeals held, however, that the Tax Court erred in reaching this conclusion on the basis of analyses of the taxpayer's marketing arrangements rather than on proof of prices charged between similar uncontrolled taxpayers. Under these circumstances, where the Tax Court employed an erroneous standard of the taxpayer's burden of proof, the government conceded that it was appropriate to permit the taxpayer an opportunity to adduce additional evidence on a remand where the correct standard would be employed. Here, however, the Tax Court applied the correct burden of proof standard and petitioners failed to meet that burden.

4. Petitioners renew their suggestion (Pet. 11-12), advanced in the courts below, that the Commissioner's allocations were inproper because the result achieved is the same as would have followed from disallowance under Section 269 of the surtax exemptions of the corporations from which the income was reallocated to petitioners. But Congress specifically contemplated the possibility that Sections 269 and 482 would be alternative means for combatting the use of multiple corporations for the purpose of gaining additional surtax exemptions. Thus, S. Rep. No. 2375, 81st Cong., 2d Sess., p. 70, states:

> It is not intended, however, that the exemption of the first $25,000 of a corporation's surtax net income from the surtax shall be abused by the splitting up, directly or indirectly, of a business enterprise into two or more corporations or the forming of two or more corporations to carry on an integrated business enterprise. It is believed that sections 45 [now Section 482] *and* 129 [now Section 269] will prevent this form of tax avoidance. [Emphasis supplied.]

5. Finally, petitioners urge (Pet. 12-13) that the disallowance by the Commissioner of the surtax exemptions under Section 269 after taking no such action in prior audits is a violation of their rights to due process. The Commissioner, however, is not estopped from correcting past errors of his agents in auditing returns for earlier years. *Automobile Club* v. *Commissioner*, 353 U.S. 180. The only proper question is whether the action taken for the year in issue is correct. The courts below correctly held that it was, and there is no reason for further review by this Court.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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